Washington State Retirement Systems and Pension Funding

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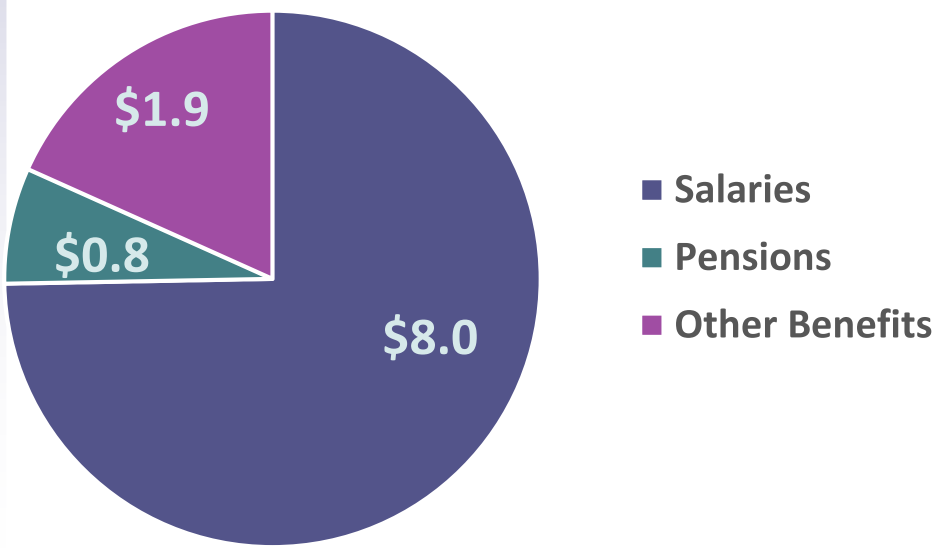
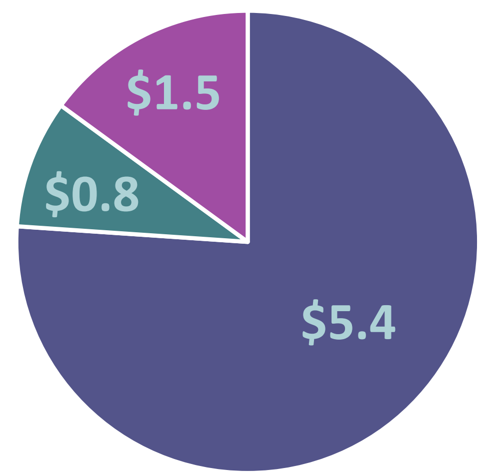
Pensions are about 7.8% of State and Higher Education employee compensation costs, and 10.3% of State K-12 compensation costs (FY 2018).

Total State Funds, State and Higher Education Employees - Fiscal Year 2018, billions



2017-18 School Year State Expenditures, billions



The "State Pension System" could be thought of as three interconnected activities

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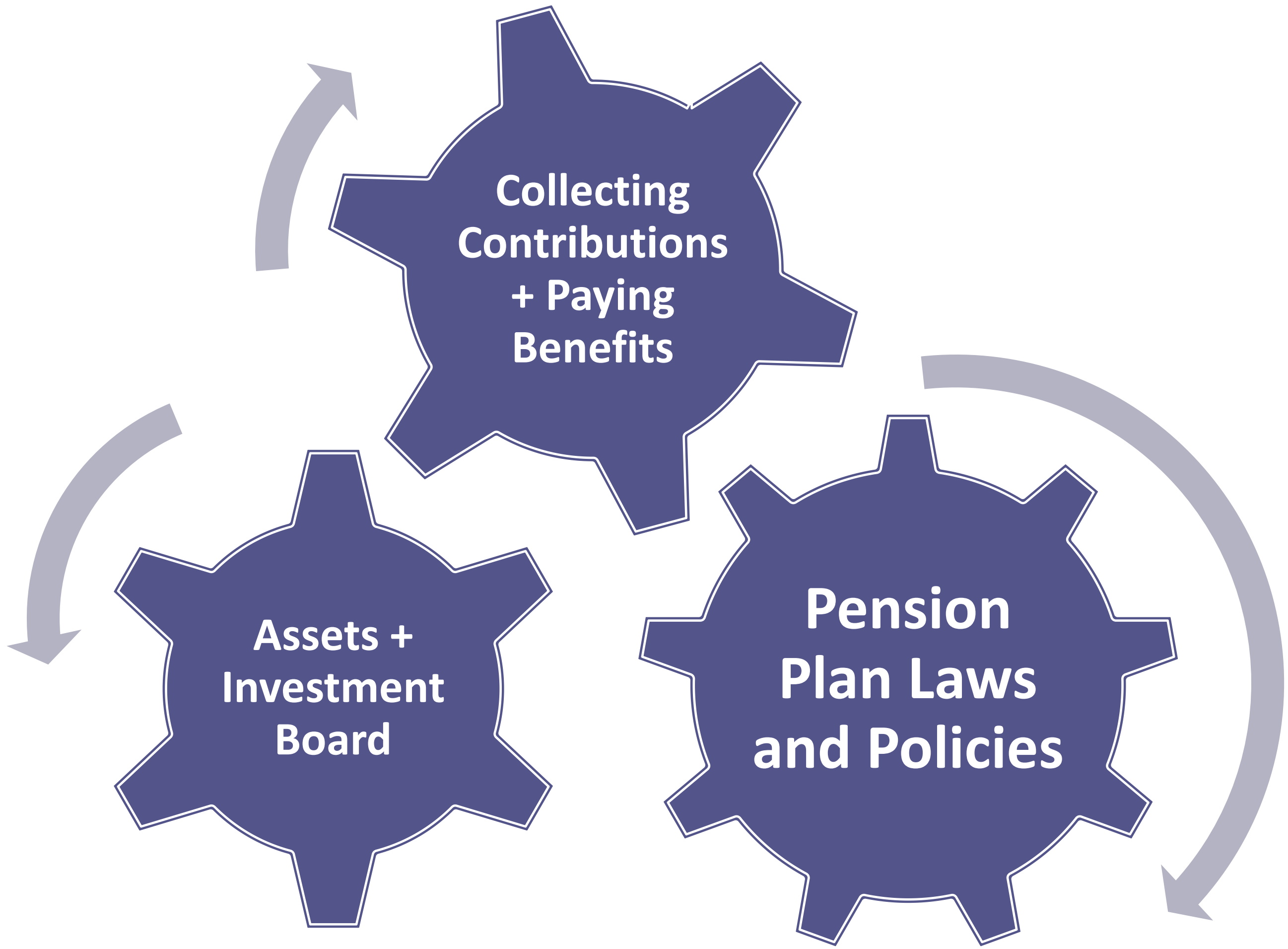

I. Plans and Demographics

II. Governance and Legal Considerations

III. Funding and Contributions

IV. Unfunded Liabilities – PERS and TRS Plans 1, HERPs

Public pension systems follow three broad designs; Washington operates some of each.

- Defined Benefit Plans
  - Pension is based on an established formula, typically a combination of years of service, salary, and age.
  - Contributions and investment return are calculated to be sufficient to meet the average participant's lifetime costs.
- Defined Contribution Plans
  - A defined portion of salary is typically contributed to individual accounts, similar to 401(k)-type plans.
  - Since 2016, new state employees contribute at least 3 percent of pay unless they opt out.
- Hybrid Plans
  - Combine features of both defined benefit and defined contribution plans – Washington's Plan 3 design is a typical hybrid plan.

The Washington State Retirement Systems provides retirement plans to employees through more than 10 systems, many with various "plans".

- The system serves about 500,000 state and local participants, active employees and retirees.
- Employee types are collected into different retirement "systems" including:
  - Public Employees' Retirement System (**PERS**)
  - Teachers' Retirement System (**TRS**)
  - School Employees' Retirement System (**SERS**)
  - Public Safety Employees' Retirement System (**PSERS**)
  - Law Enforcement Officers' and Fire Fighters' Retirement System (**LEOFF**)
  - Washington State Patrol Retirement System (**WSPRS**)
  - Higher Education Retirement Plans (**HERPs**)

The pension systems are divided into "plans" or benefit tiers.

- The plans or benefit tiers, generally follow one of three main designs:
  - **Plans 1** Most closed to entry in 1977. Employee rates fixed in statute. Defined benefit plan.
  - **Plans 2** Replaced the Plans 1. Contributions are split 50/50 between employees and employers. Defined benefit plan with leaner benefits than Plan 1.
  - **Plans 3** Hybrid defined benefit/defined contribution plans that first opened in 1996.
  - **HERPs** Defined contribution plans with employer contributions that increase to 10% with age, and a guaranteed "supplemental benefit" for those that joined before 7/1/2011, and whose benefit would otherwise be less than a PERS Plan 1-like formula.

A defined benefit is generally calculated as a function of years of service – service credit – and salary earned during that service.

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Benefit = “multiplier” X years of service credit X salary average

Benefit becomes receivable at the age/service terms of the plan.

Plan 1	Plan 2	Plan 3*
Multiplier: 2% per year of service	Multiplier: 2% per year of service	Multiplier: 1% per year of service
Service Credit: 30 years max.	Service Credit: no limit.	Service Credit: no limit.
Salary: 2 year avg.	Salary: 5 year avg.	Salary: 5 year avg.
Age: 30 years service at any age.	Age: Age 65, reduced early ret.	Age: Age 65, reduced early ret.

*Employee contributions fund individual member accounts.

PERS and PSERS are about half state employees; TRS, SERS, and LEOFF are mostly employees of local governments and school districts (2017 valuation data)

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System	Active members	Annuitants	Average Salary	Valuation Assets (millions)	Accrued Liability (millions)
PERS	159,474	98,910	$63,825	$40,233	$49,507
TRS	73,225	49,475	$75,130	$22,013	$17,256
SERS	60,412	15,941	$33,311	$4,613	$5,242
HERPs	*25,000+*	*1,100*	*$84,036*	*$39*	*$597*
LEOFF	17,734	12,079	$106,187	$16,440	$14,281
PSERS	5,822	167	$62,247	$480	$506
WSPRS	592	1,113	$91,941	$1,144	$1,245

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Other Local Government Pension Systems

- First Class Cities, as of most recent valuations

	Members and Annuitants	Contribution Rate (employer and employee)	Assets (millions)	Funded Status
Seattle City Employees' R.S.	15,818	25.0%	$2,853	69.9%
Tacoma	5,884	21.00%	$1,667	102.5%
Spokane	2,933	18.0%	$308	67.4%

- **City of Lakewood –** Defined contribution plan managed by ICMA, employer contributes 7.62% of pay, employee contributes 5.08%.
- **Sound Transit -** Defined contribution plan managed by ICMA, employer contributes up to 12% of pay, employees up to 8%.

The average recent retiree from PERS Plan 2 receives an annual benefit of about $25,000

Retirement Plan	PERS Plan 2	TRS Plan 2	SERS Plan 2	LEOFF Plan 2
Average Salary of Active Members	$65,002	$66,374*	$33,436	$106,169
Average Annual Benefit of Recent Retirees	$25,356	$28,380	$11,736	$57,576

Note: *average salary of TRS Plan 3 members, the larger group, is $78,023*

Source: Office of the State Actuary, 2017 Actuarial Valuation

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Governance of the state retirement plans

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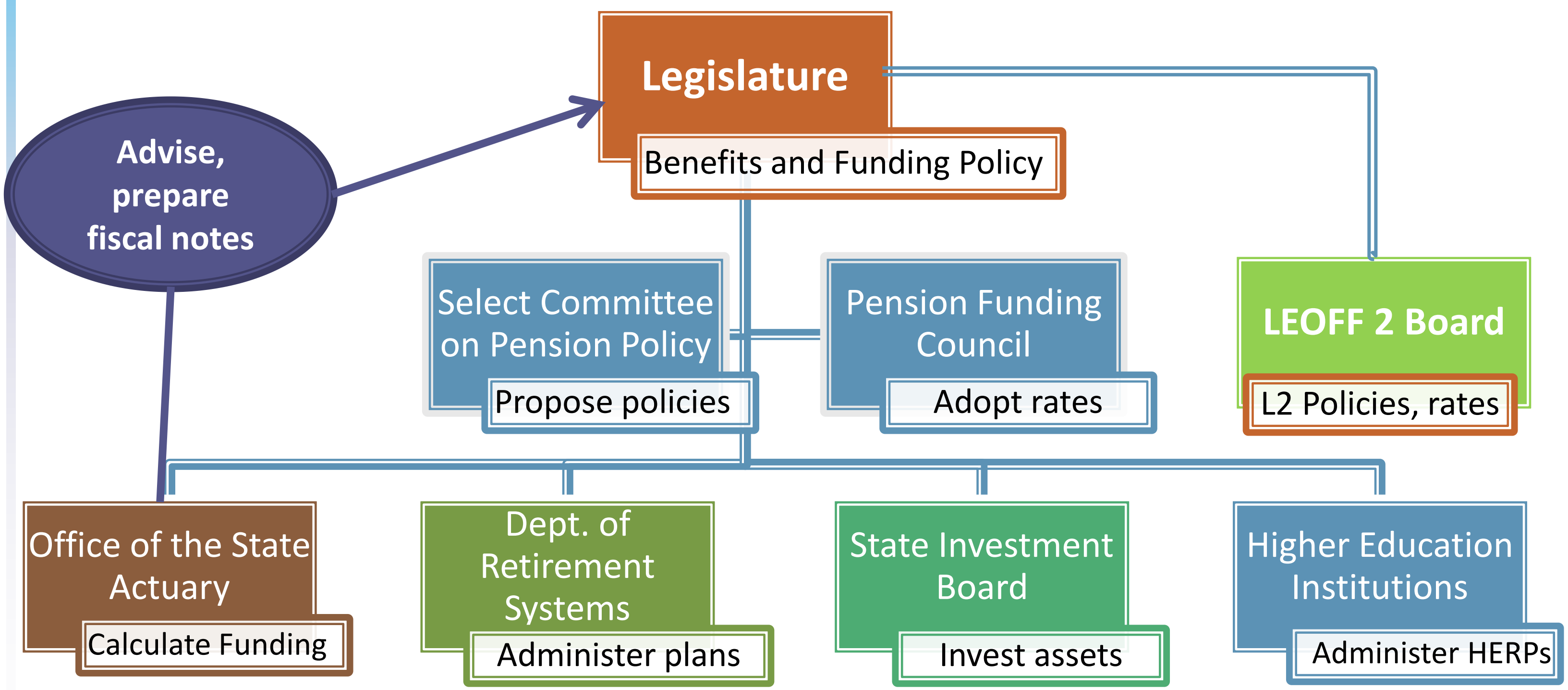

Economic assumptions are set in law; Demographic and other assumptions are developed by the State Actuary in periodic "Experience Studies".

- Core economic assumptions are initially set in RCW 41.45.035:
  - Inflation: 2.75 percent
  - General salary growth: 3.50 percent
  - Long-term investment rate of return: 7.5 percent
  - Assumptions are reviewed by the State Actuary, and may be changed by the Pension Funding Council or LEOFF 2 Board, subject to Legislative revision.
- The State Actuary completed an experience study during 2014, and recommended significant changes to mortality (life expectancy) assumptions which the Pension Funding Council elected to phase in over three biennia – 2019-21 is the last of the three.

The Washington State Investment Board (WSIB) manages more than $112 billion in a combined pension fund to meet the investment return assumptions set by the Legislature.

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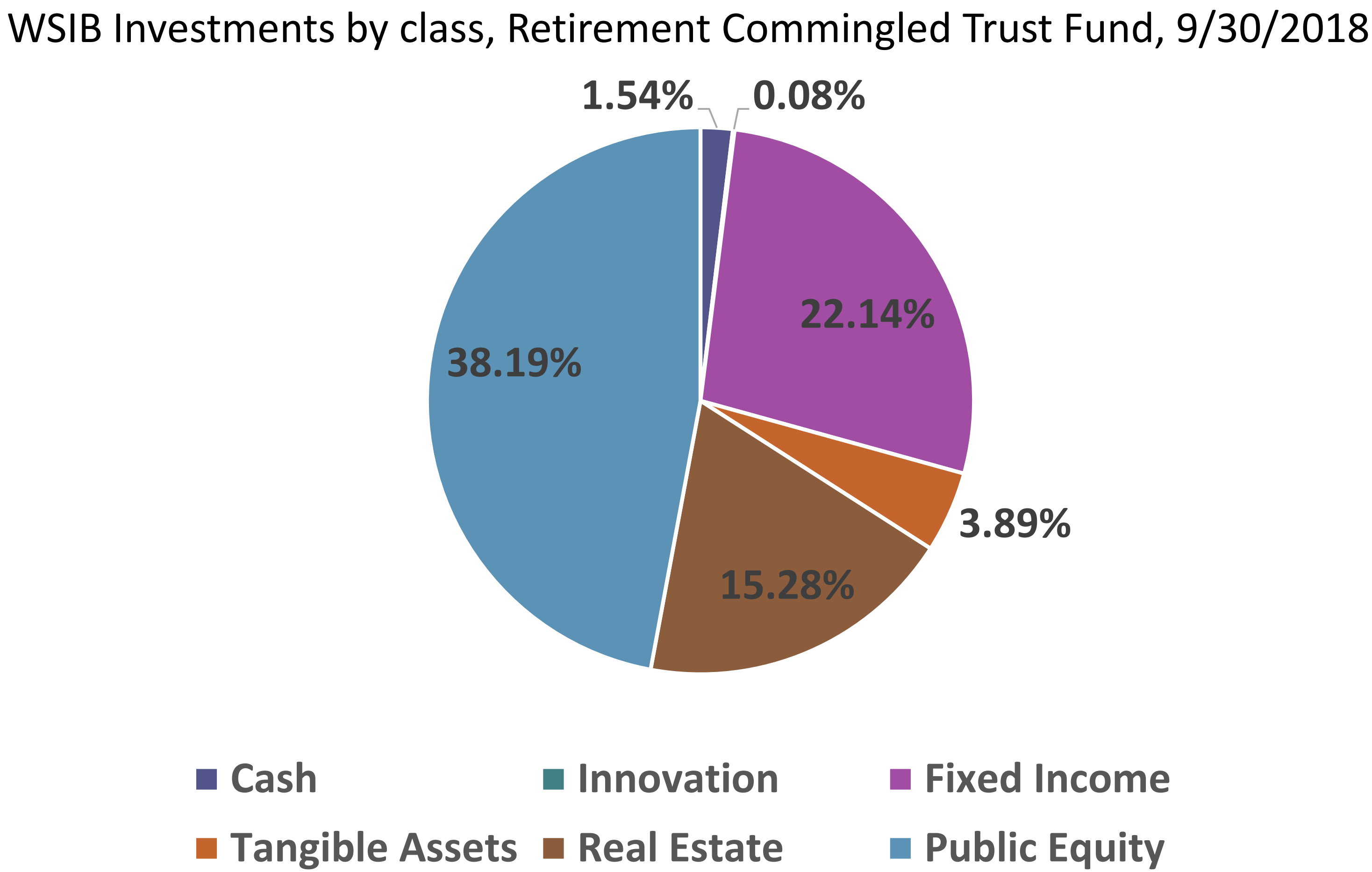
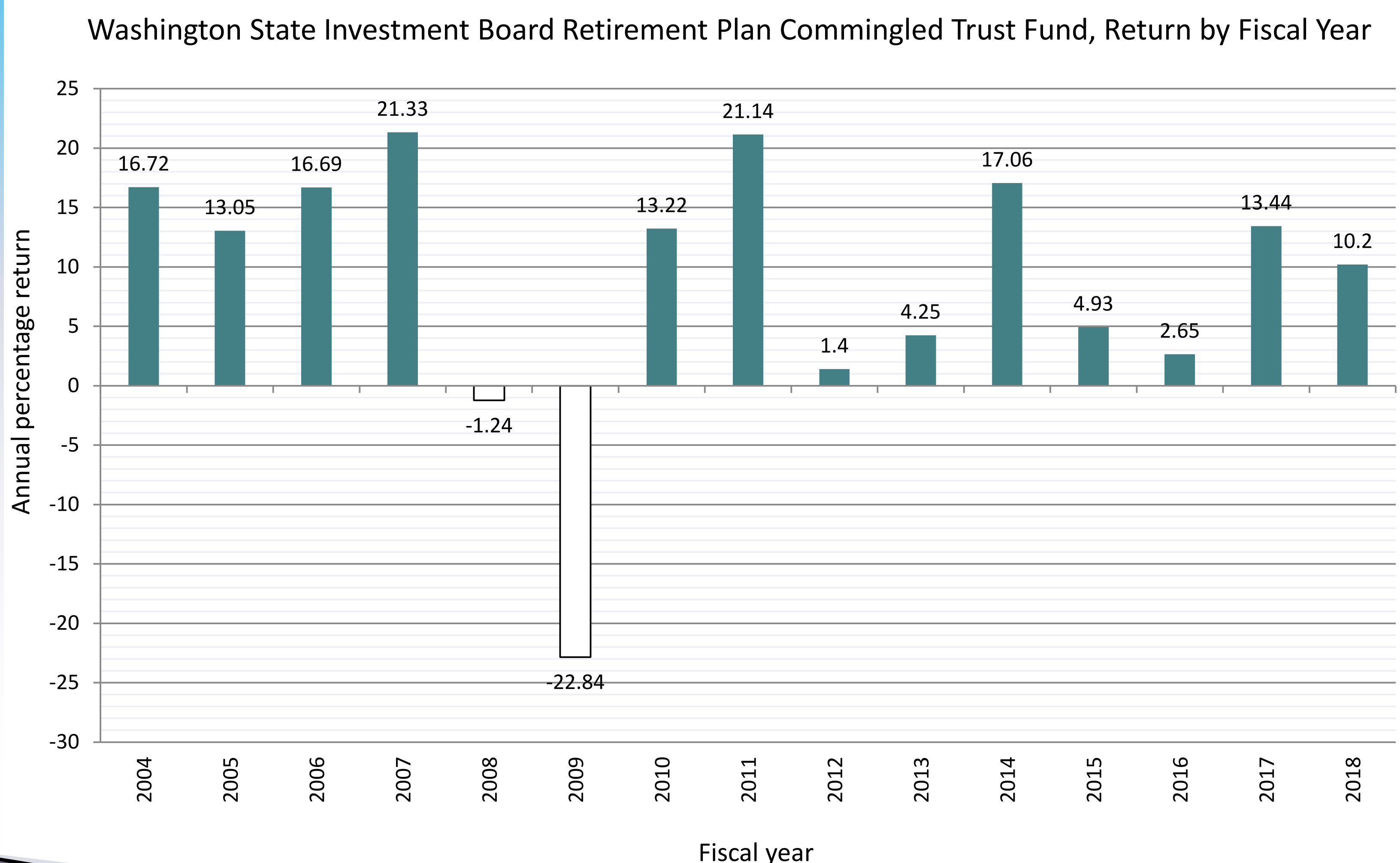


Source: WSIB, as of 9/30/18

Investment performance over the last decade has been volatile – for pension funding, gain or loss may be evaluated against the assumed rate.



State pension benefits are subject to very limited change for existing plan members; some rights also extend to the systematic funding of benefits.

- *Bakenhus v. City of Seattle*, (1956):

  "The employee who accepts a job to which a pension plan is applicable contracts for a substantial pension and is entitled to receive the same when he has fulfilled the prescribed conditions. His pension rights may be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity."

- The effect of *Bakenhus,* and following cases, is that once granted to individual members, state retirement system benefits are protected by the contracts clauses of the State and U.S. Constitutions, and are very difficult to change.

- *Weaver v. Evans, (1972):*

  "Where, as here, the (legislature's concern) has culminated in the express adoption of a systematic method of funding to ultimately attain the desired soundness, then the principle of systematic funding so adopted becomes one of vested contractual pension rights…"

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The biggest source of funding for pension benefits is investment return from pre-funding.

- The State funds pensions from three main sources:
  - Employer contributions
  - Employee contributions
  - Investment returns (about 75 percent of the total)

- Contribution rates fluctuate based on current and projected benefit costs (liabilities) and current and projected investment returns on the pension funds (assets).

- State law requires the State Actuary to use a "smoothing method" to reduce the volatility that normal year-to-year investment returns could cause for employer and employee contribution requirements.

Pension benefits are not paid directly from the budget – but the impact of benefit changes on long-term contribution rates are. The rate impacts are calculated for the short and long-term in Actuarial Fiscal Notes produced by the Office of the State Actuary.

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RESPONDING AGENCY:

Office of the State Actuary

Fiscal Budget Determinations:

As a result of the higher required contribution rate, the increase in funding expenditures is projected to be:

Costs (in Millions):	**PERS**	**TRS**	**SERS**	**PSERS**	**Total**
2007-2009					
General Fund	$0.7	$3.2	$0.4	$0.2	$4.5
Non-General Fund	1.1	0.0	0.0	0.0	1.1
Total State	1.8	3.2	0.4	0.2	5.6
Local Government	2.7	2.0	0.6	0.0	[illegible]
Total Employer	4.5	5.2	1.0	0.2	[illegible]
Total Employee	$0.0	$0.0	$0.0	$0.0	$0.

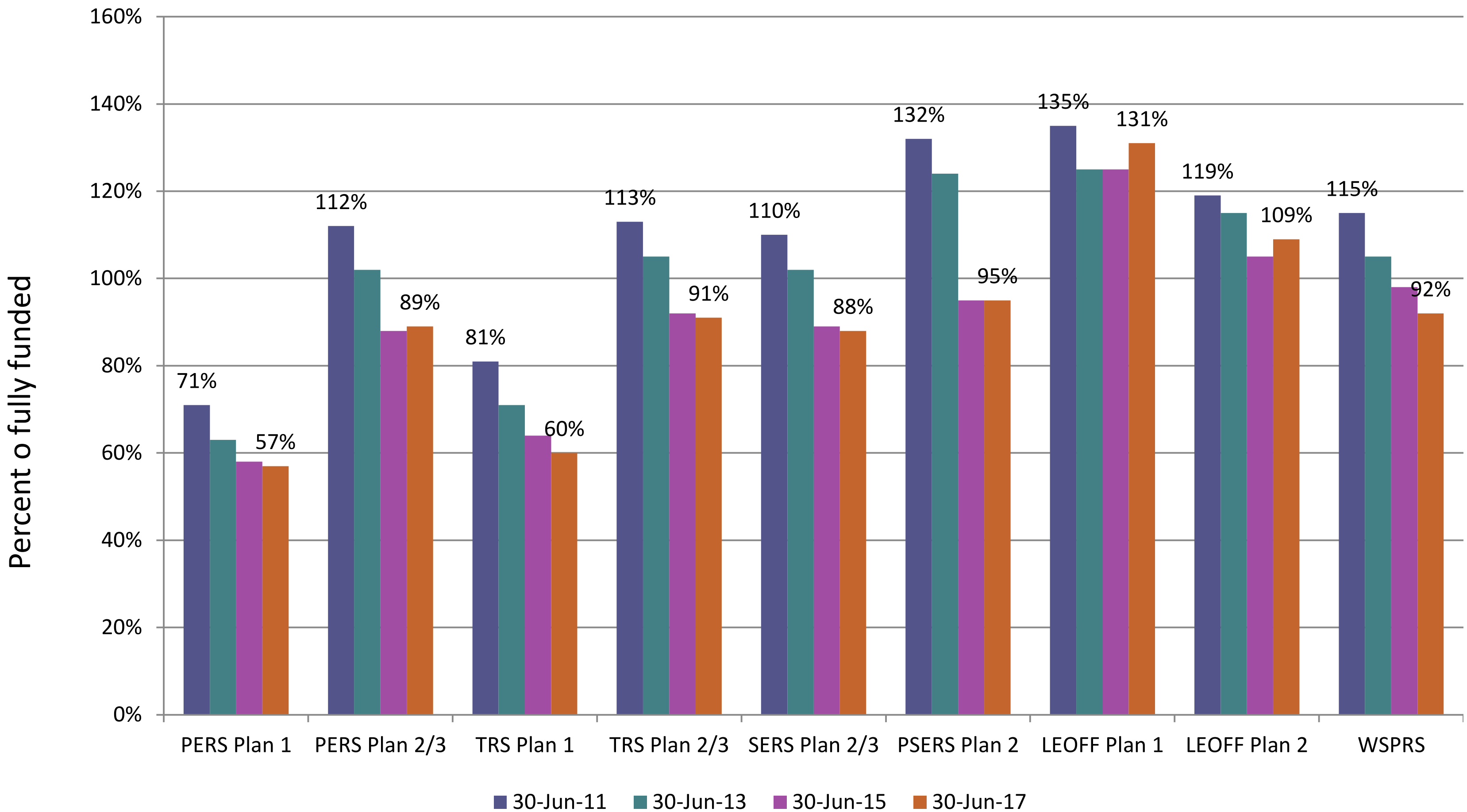
SHB 1128 - S COMM AMD
By Committee on Ways & Means

NEW SECTION. Sec. 713. FOR THE OFFICE OF FINANCIAL MANAGEMENT--CONTRIBUTIONS TO RETIREMENT SYSTEMS

General Fund--State Appropriation (FY 2008) $2,200,000

General Fund--State Appropriation (FY 2009) $2,300,000

Funded ratios in the State Retirement Systems declined between the 2011 and 2017 Actuarial Valuations – but improved due to strong investment returns in the most recent valuation



Source: Office of the State Actuary

Pension Funding Council 2015-17 adopted contribution rates continue to rise, due in parts to assumption changes and recognition of past investment losses.

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Retirement System	2017-19 Biennium		2019-21 Biennium (PFC and L2 Board adopted rates)	
	Employer*	Plan 2 Employee	Employer*	Plan 2 Employee
PERS	12.78%	7.41%	12.86%	7.90%
TRS	15.41%	7.06%	15.51%	7.77%
SERS	13.58%	7.27%	13.19%	8.25%
LEOFF 2**	9.03%	8.75%	8.77%***	8.59%
PSERS	12.38%	7.07%	12.14%	7.20%
WSPRS	13.34%	7.69%	22.39%	8.45%

*Includes DRS administrative rate of 0.18%.
**LEOFF Plan 2 rates are adopted by the LEOFF 2 Board.
***Represents State plus local government employer.

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The Unfunded Actuarial Accrued Liabilities (UAAL) are related to benefits earned in the past that were not fully funded. Collectively, State pension plans have about $13 billion in UAAL

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- TRS and PERS Plans 1 had about $9.3 billion in unfunded accrued liability at the time the current (2017) actuarial valuation was done.
- PERS, TRS, and SERS Plans 2/3 are also less than fully funded and under the Entry Age Normal cost method have about $4.7 billion in unfunded liability.
- Unfunded liabilities in the HERP plans (about $550 m) have not generally been considered as part of this UAAL total.
- LEOFF Plans 1 and 2 have a surplus of about $2.2 billion.
- A number of factors contributed to the creation of the unfunded liabilities including:
  - retroactive benefit increases and subsequent under-funding for the increases;
  - low investment returns followed by deferred contributions; and
  - not adopting and funding a plan for future benefit obligations.

Both normal and UAAL costs have increased in recent fiscal years, together exceeding $1 billion per year, but are projected to begin decreasing in the 2021-23 biennium.

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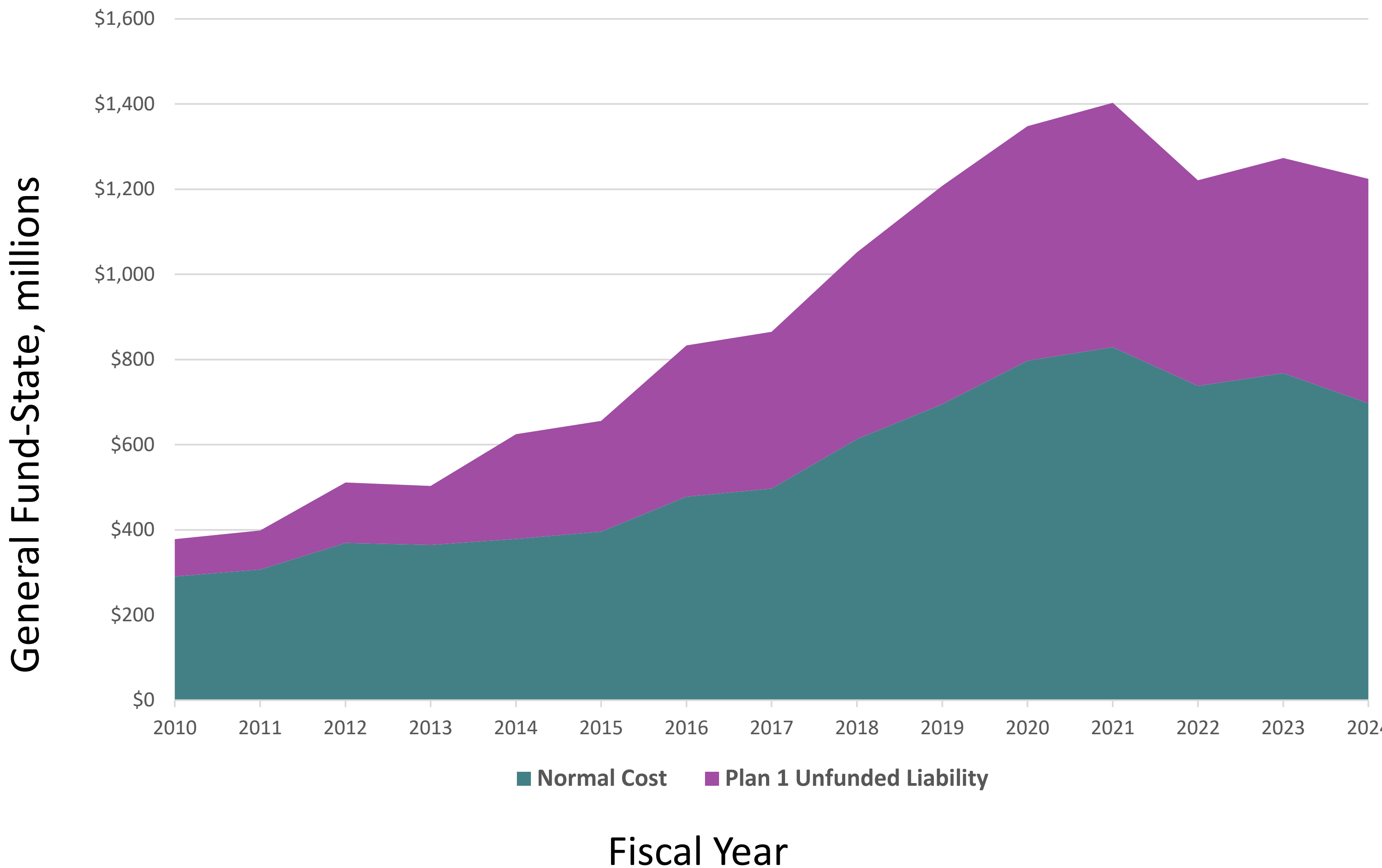

Source: Office of the State Actuary. Includes PERS, TRS, SERS, PSERS, LEOFF 2, and WSPRS.

PERS and TRS 1 Unfunded Liability (UAAL) dropped and then returned, generally following investment returns, plan changes, and most recently assumption changes.

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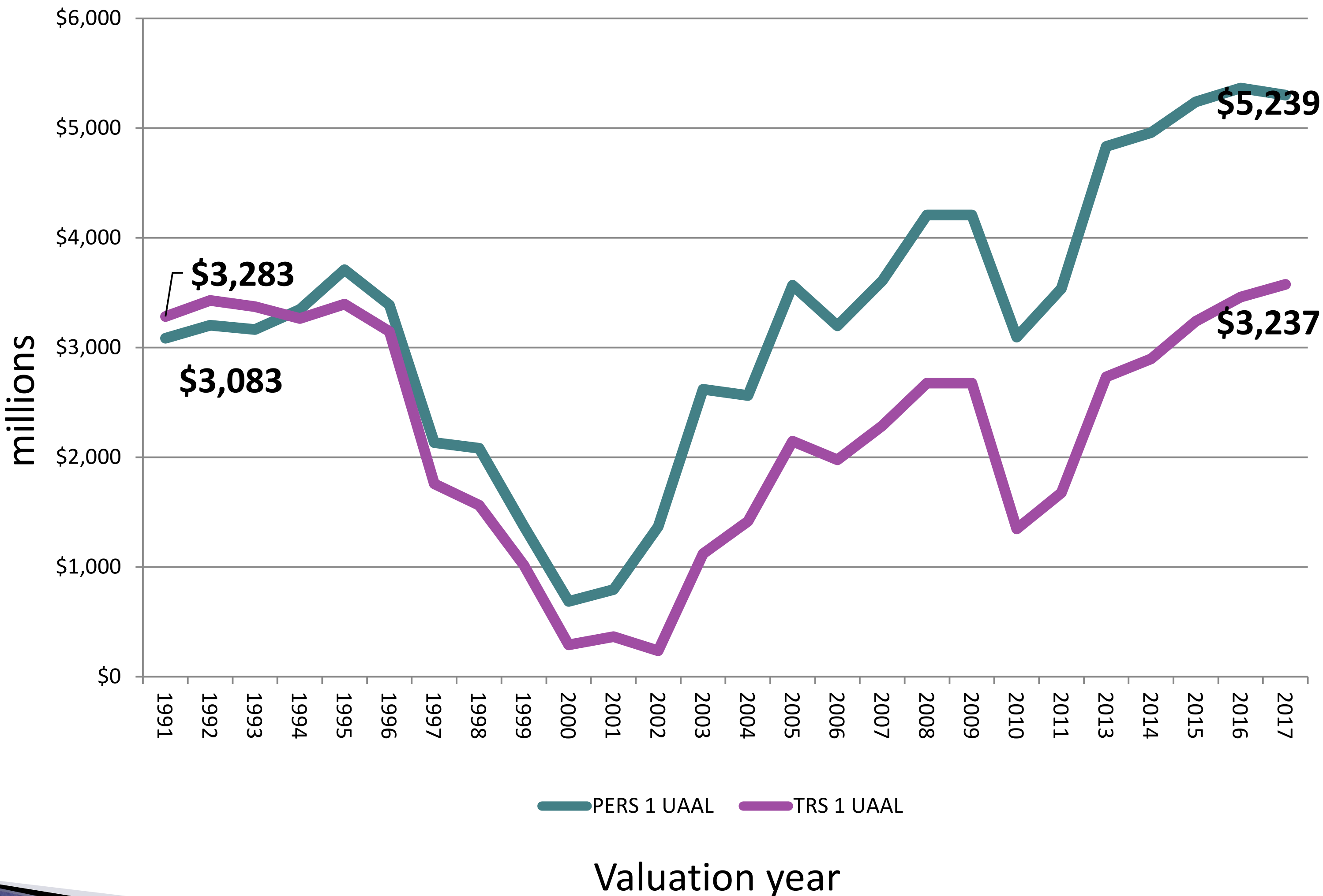

The Higher Education Retirement Plans defined benefits are almost unfunded, and annual supplemental benefit payments are expected to increase by ten times.

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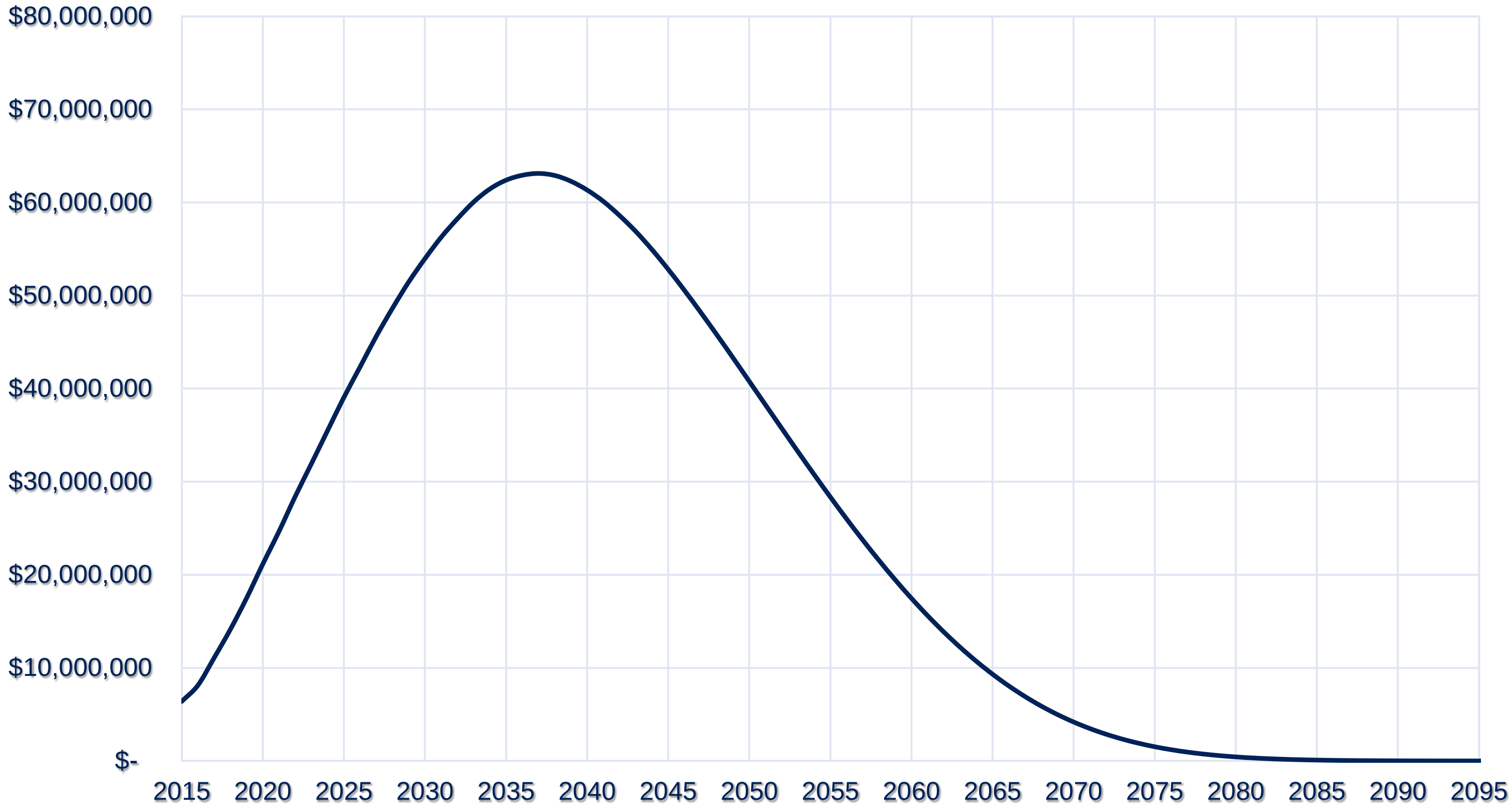

Scenario: Best Estimate Salary Scale: 4% CREF Assumed Return: 6.75%

Source: Office of the State Actuary, June 21st, 2016 *Higher Education Supplemental Valuation* SCPP presentation. Results above based on preliminary analysis.

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Appendicies

In 2014, the Court upheld the Legislature's authority to condition the granting of additional benefits with a right to change them in the future.

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The Supreme Court of Washington decided in gain-sharing, *WEA et al. v. DRS*, 181 Wn.2d 212 (2014) and similarly the Uniform COLA case, *WEA et al. v. DRS*, 181 Wn.2d 233 (2014), that:

> "The employees' contract rights were impaired, if at all, by the legislature's 1998 enactment of the gain-sharing program and its reservation of the right to amend or repeal the program in the future....
>
> Properly framed, it is obvious that gain sharing did not impair the employees' preexisting contract rights.... **<u>The legislature is allowed to condition its grant of pension enhancements using express language in the statutory provision that creates the right</u>**."

WEA et al. v. DRS, 181 Wn.2d 212, 223 (2014)

Benefit reductions were enacted for many of the retirement plans by the Legislature in recent years.

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- 2007: Elimination of gain-sharing and the provision of “replacement” enhanced early retirement benefits.
- 2011: Repeal of the uniform COLA; PERS and TRS Plans 1 unfunded liability was reduced by $3.7 billion.
- 2011: Elimination of Supplemental Benefits for new enrollees in the HERP plans; PERS and TRS Plans 1 expanded “retire-rehire” rules repealed.
- 2012: Reduction of early retirement benefits for new members of PERS, TRS, and SERS Plans 2 and 3.